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**PROVINCIAL REPORT
ON THE
REVISED EQUALIZATION PROGRAM
PROPOSED IN THE
NOVEMBER 12, 1981 FEDERAL BUDGET**

Federal-Provincial Meeting of
Finance Ministers and Provincial Treasurers

Toronto, Ontario
December 14 - 15, 1981

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A. INTRODUCTION

This report represents an initial provincial response to the November 12, 1981, federal Budget proposal calling for major revisions to the equalization formula to take effect in the 1982/83 fiscal year -- that is, approximately three and one-half months from now.

The provinces wish to place on the record a number of reservations about the recent federal equalization proposal itself, and about what we regard as an inadequate timetable for federal-provincial review and consultation.

If implemented, the proposal in the November 12th Budget would be the most fundamental and far-reaching change in the equalization arrangements since the present "representative tax system" approach was introduced fifteen years ago. However, the federal government has offered provinces only a few months, at most, to review and discuss these changes before it plans to introduce legislation to bring them into effect for the next five years, and possibly longer. In contrast, in previous rounds of Fiscal Arrangements negotiations, the federal government and the provinces cooperated in joint consultation over a substantially longer time period, and at least general provincial concurrence was sought, and often obtained, before significant revisions were implemented.

In our view, there is insufficient time remaining in the current fiscal year for a fully satisfactory joint assessment of the immediate and longer-term implications of the November 12th proposal. Consideration must be given to an extension of the present arrangements on an interim basis beyond 1981/82, pending completion of a detailed federal-provincial review of the federal proposal and of alternatives.

A substantial measure of federal-provincial agreement is essential on the equalization formula in order that it may truly be a cornerstone of Confederation -- a hallmark of cooperative financial arrangements between the federal and provincial governments.

B. BACKGROUND

The decision to incorporate the principle of equalization as a key provision in the Constitutional Resolution has helped give Canadians in all provinces a greater appreciation of one of the most important features of our federal system.

As was noted in the Budget paper, Fiscal Arrangements in the Eighties --Proposals of the Government of Canada,

"For 25 years the federal government has been making equalization payments to financially disadvantaged provinces enabling them to provide a reasonable standard of public services to their residents. There has been widespread and continuing public support for equalization...from all parts of Canada...." (page 11)

It should be emphasized that those transfers ultimately arise from contributions made by individual taxpayers in every part of Canada, including those in the recipient provinces themselves.

Clear evidence of strong public support for equalization can be found in recent joint position statements by the ten provincial governments. In 1976, a consensus statement by the Provincial Finance Ministers and Treasurers described the equalization program as "the cornerstone of Canadian federalism," and the same year, the ten Premiers, at their annual conference in Edmonton, issued a communique which stated:

"...A strong equalization system which compensates fairly for fiscal capacity deficiencies among the provinces must remain among the federal government's highest priorities. (The Premiers) agreed that the federal government should not apply arbitrary limits to its expenditures under the general equalization formula. They stated that they would oppose any such attempt in the strongest possible terms and would also oppose any effort by the federal government to reduce its relative level of support for the equalization program in the future."

In August, 1981, at their most recent conference in Victoria, the Provincial Premiers reaffirmed their support for equalization, emphasizing again that "a strong equalization program must remain a key element in federal-provincial Fiscal

"Arrangements" and agreeing as well that "a representative tax system for calculating equalization is the most appropriate system." In the same statement, the Premiers referred to the desirability of resolving certain issues affecting the current arrangements which had resulted in the introduction of ad hoc changes by the federal government. At the same time, they also stressed that "reductions in payments to recipient provinces would be unacceptable since such measures would lead to increases in fiscal disparities."

Although Canada has had a formal equalization system in effect for 25 years, the current fiscal year, 1981/82, marks the fifteenth year of operation of a comprehensive "representative tax system" formula for calculating provincial entitlements. The present system was introduced by the Pearson government in 1967/68 "following lengthy study by the federal government and the provinces," as was pointed out in the April, 1981 submission by the federal Minister of Finance to the Parliamentary Task Force on Fiscal Arrangements. At the time the formula was introduced, the Honourable Mitchell Sharp, then Minister of Finance, stated:

"We should seek in future to measure the whole revenue or fiscal capacity of the provinces - develop a comprehensive 'prosperity index' if you will - in place of the partial measure now in use. Instead of selecting certain taxes and equalizing them to the level of the top two provinces, we should take into account all of a province's revenues and equalize them to the national average. This would be a good deal more expensive to the federal Treasury, but far more equitable."

The formula introduced in 1967/68 was extended largely unchanged for a second five-year cycle in 1972/73. However, it was modified shortly thereafter to include school-purpose taxes. Then a number of changes were effected -- both before and after its further extension for another five years in 1977/78 -- primarily to limit its application to non-renewable natural resource revenues, and thereby to restrain the costs of the program.

These modifications -- including the 50% ceiling on non-renewable resource revenues to be equalized, the one-third "cap" on resource-related equalization payments, the phasing out of payments in respect of oil and gas land sales, and the ineligibility provision for provinces with above-average personal incomes -- have maintained

the costs of the equalization program at a relatively stable level in relation to total federal expenditures in recent years. Thus, the program has not represented a source of excessive pressure on the federal Budget.

As noted earlier, the ad hoc nature of some of the recent changes has been of concern to both orders of government, and the provinces have indicated a willingness to work with the federal government in exploring options for improving the present arrangements, to minimize the need for such changes in future.

C. THE IMPORTANCE OF EQUALIZATION TO THE RECIPIENT PROVINCES

Canada's equalization formula has played a major role in assisting provinces with below-average revenue-raising capacities to provide their citizens with a broad range of essential public services. The following table indicates the relative importance of equalization to the budgetary positions of the recipient provinces:

Equalization Entitlements
As a Percent of Gross General Revenues
(approximations - based on 1980/81 data)

Newfoundland	25%
Prince Edward Island	30%
Nova Scotia	25%
New Brunswick	22%
Quebec	11%
Manitoba	16%
Saskatchewan	3%

Concern has been expressed that even the formula currently in place is not providing adequate support. Any reduction in federal support for the equalization program, either in absolute or relative terms, could imply further increases in tax burdens in the provinces affected.

D. THE NOVEMBER 12TH FEDERAL BUDGET PROPOSAL

The proposal for changes in the equalization arrangements which was put forward in the November 12, 1981 federal Budget was argued to represent a major "improvement" over the present arrangements. However, in assessing the proposal to date, provinces have found it difficult to find a basis for the assertion that the formula would be "improved" if the Budget proposal were implemented. In fact, on balance and overall, the provinces believe that the changes being proposed may represent a backward step -- undermining key elements of a formula which has served Canada well for a decade and a half.

The proposal does not simply involve extensions to the present system, but instead represents a major departure from the present formula. In his statement to the Parliamentary Task Force on Fiscal Arrangements in April, 1981, the federal Minister of Finance stated that the present equalization program "is already, in my view, one of the best programs of its type in the world." In light of that statement, the dramatic changes proposed in the November 12th Budget are all the more surprising. In addition, it is important to note that the Parliamentary Task Force stated in its report in August that:

"The Task Force...sees the development of the equalization program over the next five years as being very much an extension of its present scale and structure....

"The Task Force concludes that the basic features of the equalization program should be maintained. The various adjustments recommended...do not involve radical changes. They are very much in line with the principles and assumptions underlying the current formula. Indeed, they are meant to make those principles and assumptions more relevant to its actual functioning. The Task Force has no doubt that this formula, which has been in place since 1967, has served Canada well and that the changes made to it in recent years have preserved, rather than impaired its validity. Our recommendations should be perceived as an attempt at "fine-tuning" the current formula, and certainly not as a criticism of what has been done in the recent past." (Report of Parliamentary Task Force on Fiscal Arrangements - page 171.)

E. MAJOR PROVINCIAL CONCERNS

Following is a summary of the major provincial concerns about the federal proposal which have been identified up to now. Again, it should be emphasized that provinces have had relatively little opportunity to assess the proposal in detail -- far too little time to permit a fully-satisfactory evaluation.

1. The Standard of Equalization

The proposal to adopt Ontario's tax base instead of the national average as the benchmark for calculating equalization entitlements is one of the most important and troublesome changes proposed in the November 12th Budget. While the federal government has attempted to justify its proposal on the grounds that Ontario's overall situation is reasonably "representative" of circumstances in the equalization recipient provinces, this proposed change is a major departure from the national average "representative tax system" approach.

Several provinces have made the point that Ontario's lack of a non-renewable energy resource base would effectively eliminate equalization in respect of such revenues. At the same time, to the extent that provinces with substantial resource revenues use them to maintain lower general tax rates, equalization payments would be reduced.

The use of a single province as the standard also suggests potentially serious problems of instability. The use of the national average as the standard for calculating entitlements under the present formula has meant that temporary or longer-term shifts in the pace of economic activity, and their impact on tax bases, have been "smoothed out" somewhat in their impact on equalization calculations. However, the substitution of a single province as the standard would increase the vulnerability of recipient provinces to significant fluctuations in entitlements based on developments in the benchmark province.

Equalization payments should ensure provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. At a time of major adjustment in the Canadian economy, the provinces believe that it would be inappropriate to select a single province as the standard.

2. The Measurement of Fiscal Capacity

The federal Budget proposes to expand the total revenues considered in equalization calculations by returning to the original system of full inclusion of resource revenues and by adding, for the first time, municipal revenues from taxation.

The Federal Budget implied that the return to a more comprehensive treatment of resource revenues would represent an improvement in the formula. In fact, however, this change, in conjunction with the proposed introduction of the "Ontario standard," would have a major negative effect on resource-related equalization payments because Ontario lacks a large-scale natural resource base against which other provinces' taxing capacities would be measured.

Federal estimates indicate that resources-related equalization payments would effectively be eliminated under the proposed formula in 1982/83. In contrast, the most recent estimates for 1981/82 under the present formula indicate that resource revenue equalization accounted for close to 30 percent of total entitlements.

The other major change in the measurement of fiscal capacity, as noted above, involves the proposal to include municipal revenues from taxation. A change along these lines has been advocated for some time. However, the federal proposal would continue to exclude a substantial proportion of local government revenue from equalization calculations -- that is, municipal revenues from sources other than taxes.

3. Financial Disincentives for Economic Development in Equalization Receiving Provinces

The proposed use of the Ontario standard for calculating equalization also gives rise to concerns about inordinate financial disincentives for governments in equalization-receiving provinces when undertaking certain types of development activity.

While provinces would expect their equalization entitlements to be reduced as their economic and tax bases are strengthened, there is concern that the rate at which this reduction takes place should not discourage important development initiatives. The use of the Ontario standard in conjunction with the present tax bases would have the effect of causing provinces experiencing certain types of development, particularly in the resource field, to face circumstances under which they would receive either no net revenue benefit whatsoever, or a reduction in net revenues, where returns from resource developments were offset by reductions in equalization of 100% or more. Included with this report is an appendix illustrating the disincentive problem under the proposed formula. It is recognized, of course, that somewhat similar -- though less extensive -- problems exist with the present arrangements.

The provinces believe that the resolution of these types of disincentive should be a major priority for federal-provincial study.

4. The G.N.P. "Cap"

The federal government suggests that overall payments under the revised formula be subject to an upper limit based on the rate of growth of G.N.P. It is argued that this limit would offer the federal government protection against substantial and unforeseen increases in the cost of equalization over time.

While resource revenues and related equalization have been capped in various ways -- both in the past and under the present formula -- the change now being proposed would mark the first time that overall equalization payments were made subject to an arbitrary growth ceiling.

As in 1976, the provinces strongly oppose such a ceiling in principle, believing that it could interfere with the ability of the formula to reflect changing economic circumstances across the country.

It has also been pointed out that the application of a G.N.P. ceiling in conjunction with the introduction of the Ontario standard would mean that in years when the growth in the standard province exceeded the national average, equalization

recipient provinces would not see growth in their entitlements keep pace. Conversely, however, when growth in the standard province proved to be less than the national average, overall equalization entitlements would be limited to that same lower growth rate.

According to federal estimates, the G.N.P. cap would apply in at least the first year of the new arrangements -- thus indicating that receiving provinces would immediately begin to "fall behind" under the new formula.

Equalization is "not a program like the others;" it must be assigned a special national priority, not subject to arbitrary restrictions which would reduce its effectiveness in supporting essential services at the provincial and local level.

5. Economic and Revenue Growth Assumptions

The estimates of entitlements under the proposed formula contained in the federal Budget are based on a variety of assumptions with respect to national and provincial economic and revenue trends in the short and medium terms. A number of provinces have expressed concern about the validity of these assumptions given the current uncertainties facing the Canadian economy. Substantially more work is required to assess the forecasts and the responsiveness of the proposed formula to changing economic circumstances.

6. General Tax Base Modifications

In past rounds of federal-provincial equalization negotiations, considerable attention has been focussed on modifications to the standardized measurements of provincial tax bases used in the formula. On this occasion however, comparatively little discussion has centred on this topic, although provincial views have been solicited.

The provinces believe that possible tax base modifications should receive detailed consideration at the officials' level early in the new year in conjunction with the other federal-provincial consultations on the equalization program.

7. Comparison of Entitlement Estimates Under Present and Proposed Arrangements

The federal government has provided some limited information on the financial implications of its equalization proposals for the receiving provinces. However, the federal documentation made available to date has not included formal estimates of potential entitlements under the present formula if it were to be continued past the end of 1981/82.

In the absence of formal federal estimates, provincial governments have prepared their own forecasts of potential entitlements under the present arrangements, using assumptions and other information comparable to those used in federal forecasts of entitlements under the proposed system.

The following table summarizes estimated equalization entitlements under a continuation of the present formula for current equalization recipient provinces, and compares those payment flows with federal estimates of projected payments under its proposal.

These estimates take into account a recent updating of data on tax base shares for 1980.

Table 1

EQUALIZATION PAYMENTS TO THE SIX RECEIVING PROVINCES* **1982-83 to 1986-87** **(\$ million)**

	<u>Present Formula</u>	<u>Federal Proposal</u>	<u>Estimated Difference</u>
1982-83	4,736	4,089	647
1982-84	5,562	4,615	947
1984-85	6,139	5,093	1,046
1985-86	6,781	5,620	1,161
1986-87	7,495	6,166	1,329
Five-Year Total	30,712	25,582	5,130

*The latest available estimate of equalization payments associated with Established Programs Financing tax transfer, and accounted for under E.P.F., is netted out from these numbers.

As the table indicates, the proposal would significantly reduce the federal commitment to equalization relative to a continuation of the current formula. The estimated federal cash savings are over \$5 billion during the next five years.

Moreover, the increase in entitlements in 1982/83 would not be 14.4% as claimed in the federal budget, but 8.3%. The federal calculation of 14.4% incorrectly includes equalization associated with E.P.F. tax points.

Current estimates also suggest a significant loss for Saskatchewan which is not included in the above totals.

F. CONCLUSION

Although provinces have had barely a month to review and assess the federal equalization proposal included with the November 12th Budget, it is clear from the issues and concerns raised in this paper that implementation of the proposal in its present form would mean the most significant change in Canada's equalization arrangements in at least a decade and a half -- and a much more important departure from the present system than has been generally understood up to now.

While the present system is subject to a number of valid criticisms, the provinces do not, at this time, regard the federal proposal as a satisfactory "improvement" over the the current arrangements.

All provinces are prepared to cooperate fully with the Government of Canada in considering alternatives and modifications to the present and proposed systems. Several promising possibilities are currently being explored by provincial governments.

In our view, sufficient time must be permitted, not only for the development of such alternatives, but also for a thorough review of the numerous concerns raised in this report about the November 12th proposal.

In order to ensure adequate time for such work, the provinces urge the federal government to continue using the present equalization formula for calculating interim payments beyond the end of 1981/82. It is assumed that when a substantial measure of agreement is reached, modifications could be made retroactive to April 1, 1982.

Provinces also believe revisions must be developed cooperatively by the federal and provincial governments; they must not be imposed unilaterally by the Government of Canada.

APPENDIX

ILLUSTRATION: FINANCIAL DISINCENTIVES FOR GOVERNMENTS

While the present equalization system contains serious disincentives with respect to the development of provincial mineral resources, these effects will be magnified under the federal proposal.

Essentially the problem with respect to mineral revenues arises because of the allocation of the tax base on the basis of a value added calculation which may bear no relationship to the economic rent actually generated by a province's mineral industry. Thus a province with an extremely rich mineral resource is assumed to have the same capacity to collect economic rent from the resource as is a province with a more economically marginal mineral endowment.

The Province of Newfoundland provides a graphic example of the problems which can arise from such a situation. While Newfoundland has a very large mining industry, almost all production is centered on iron ore deposits located in central Labrador. These deposits are relatively low-grade and this factor, when coupled with high operating costs as a result of climate and distance from tide water, renders these operations relatively uncompetitive when compared to higher-grade and better-situated deposits in Australia and South America. The numerous layoffs and temporary shut-downs of these operations in recent years, when coupled with the Iron Ore Company of Canada's 1980 announcement that it would suspend production indefinitely at its operations located along the Quebec/Newfoundland border near Schefferville, provide ample evidence of the low economic rent associated with these operations.

Table 1
COMPARISON OF MINERAL REVENUE ENTITLEMENTS 1982/83

	<u>Present System</u>	<u>Proposed System</u>
	(\$ million)	
A. Mining Taxes and Royalties	+17.5	+17.5
B. Equalization Entitlement	+10.4 (est.)	+17.5 (est.)
Assuming No Production		
C. Negative Entitlement	-31.5	-66.0
D. Total Equalization Loss (B+C)	-41.9	-83.5
Net Benefit From Mineral Production (A-D)*	-24.4	-66.0

While there can be no objection to the loss of a certain amount of equalization as a province develops its own economy, the above situation, in which the province loses close to five dollars in equalization for every dollar of own-source revenues which it collects, is clearly inequitable. In fact it would seem logical for the trade-off of resource revenues against equalization entitlements to be substantially less than 100 percent in order to provide a positive incentive for development and in recognition of the very real costs to provincial governments of providing social and economic infrastructure in remote communities based on non-renewable natural resources.

*Illustration excludes certain other revenue effects.

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Ministère du Trésor et de l'Économie
Édifice Frost, Ch. FS - 576
Queen's Park
Toronto, Ontario M7A 1Y7
(416) 965-3505

